Sandia National Laboratories

Albuquerque, New Mexico 87185

date: April 17, 2000

to: Brian Morishita, INEEL (via e-mail)

from: Evan Ashcraft

subject: Securities Lending Overview

1) **Who are you and how long have you done securities lending?**

My name is Evan Ashcraft and I am responding for the Sandia National Laboratories' pension fund investment group. Here is our address:

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Our fund has approximately $3.5 billion as of the end of the first quarter 2000. We have been lending securities with our trustee bank (The Northern Trust Company) as of October 1, 1999. However, we have been invested in two commingled funds (that are funds which lend securities) since the early 1990's. They are an S&P 500 fund at Barclays Global Investors and an EAFE fund at State Street Global Advisors.

2) **How seamless has this process been to your operation from an accounting/administrative viewpoint?**

The securities lending process has been relatively seamless to us. In the commingled funds, there is an additonal cash flow each month which simply purchases new shares of the fund. With the program at the trustee bank, there are detailed monthly reports which show the transactions involving each security that was lent during the month. There is also an expense incurred each month along with the income that accrues to the fund's cash account.

3) **Have you had any negative experiences with this process?**

Other than the housekeeping/administrative issues mentioned above (i.e., there is some work involved to maintain oversight of the program), there have been no negative experiences. One of the key variables to avoid “headline risk” is the prudent investment of the collateral fund. If the collateral fund is invested conservatively and the borrowers are screened well, the risk to an underlying pension fund seems to be minimal (see also the answer to question number 4 under mitigating risks). In fact, it could be argued that a plan sponsor is “leaving money on the table” by not participating in a conservatively run securities lending program.

4) **How effective do you perceive your trustee has been in mitigating the risks?**

The Northern Trust Company has been effective in mitigating the risks inherent in the securities lending process. This answer will be an abbreviated version of their risk management capabilities. Northern views risk management in four categories:

1. Borrower Risk – this is the risk if a borrower simultaneously defaults on a loan and there is insufficient collateral to purchase the security. Northern does a detailed assessment of borrowers to avoid financially unsound business partners. In addition, borrowed securities are marked to market daily. The collateral must be maintained at 102% of the value for domestic securities and 105% for international securities. Northern’s securities lending program has never experienced a loss due to borrower default in the history of its program.

2. Collateral Risk – the risk when an investment in the collateral pool becomes impaired or decreases in value. Northern has 9 analysts to do the credit selection process; the process has senior management oversight and the credit decisions are monitored by the Trust Credit Group. The portfolio structure is also closely monitored. Northern’s securities lending program has never experienced an investment loss in any of the collateral pools.

3. Interest Rate Risk – the risk when negative loan spreads may result in losses due to rebate rates exceeding the earnings rates on cash collateral investments. An asset liability approach is used to control interest rate risk; statistical and objective duration risk measures are used to determine interest rate sensitivity. The collateral pools in Northern’s securities lending program have never experienced a negative spread.

4. Trade Settlement Risk – the risk occurs when an investment manager sells a security that is out on loan and the borrower is unable to return the security to Northern to settle the trade. Essentially, Northern will guarantee either the security will be returned (through a reallocation procedure) or Northern will cover the proceeds as if the security had been sold. The bottom line is that securities lending will not interfere with the underlying portfolio investment strategy.

5) **Any regrets, or are you pleased with the process (overall comments)?**

We are pleased with the process. Securities lending is a good way to add some incremental income for a pension fund. With a fund our size, securities lending adds between 2 and 3 basis points on an annual basis. That may not sound like a lot in percentage terms, but the income in 2000 should be approaching $800,000.

There are a lot of factors which influence the amount of income that a securities lending program can produce. For example, in general, international equities will generate a larger lending income than would a comparably sized domestic equity portfolio. Also, fixed income portfolios do not usually generate large amounts of income, since there is usually a large supply of available bonds.

The amount of funds that a pension fund has in commingled funds is another issue that determines securities lending income; usually only securities in separate accounts are available for securities lending. However, many commingled funds will have their own securities lending programs “built in” to the fund (as noted above, Barclays Global Investors and State Street Global Advisors are two firms who offer this).

Another important factor is the negotiation of a split arrangement with the trustee; these are usually 50/50 or 60/40 (60% of the revenue goes to the client and 40% to the trustee). Also, if an existing trustee client initiates a securities lending relationship with a trustee, the trustee may be willing to negotiate a fee break on the existing trustee services, since the lending program will generate additional revenue for the trustee (through the split arrangement mentioned above). So the client may recognize additional “revenue” (cost savings) through a fee reduction at the trustee.

Please let me know if you would like to discuss any of this information further.

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